

ADVISING A CHARITY?

Avoid Common Fumbles by the Unwary Pro Bono Lawyer

By Alice M. Anderson and Sheila Warren

Good for you! You're giving back by coaching or advising a charity in your spare time. But despite your best intentions, you may know just enough to be dangerous.

The most common mistake is underestimating the scope and complexity of the laws governing charities. This area has a multilayered play-book. Many of the issues commonly presented to pro bono counsel involve federal tax law practice, with volumes of nonprofit-specific authority. Most lawyers aren't aware how constantly it comes into play. Your state also may have a separate corporate code and/or charitable trust laws that apply to nonprofit organizations, and almost certainly has other laws governing their operation. (Note that some states further regulate topics already covered by federal law.) Similarly, cities and counties have their own requirements and restrictions, which may range from charitable solicitation registration to property tax and sales tax requirements.

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To further complicate matters, charities that are categorized by the IRS as "private foundations" have their own largely counterintuitive set of restrictions and prohibitions—and violations can result in serious consequences for individuals as well as charities. Finally, depending on your client's activities, a lineup of other laws also may apply: for example, Patriot Act protective measures may be crucial for organizations operating internationally.

So what's a diligent pro bono lawyer to do? Some suggestions:

- Scan a comprehensive treatise to get an overview of the universe of tax-exempt organizations law;
- Browse the charities sections of the IRS and applicable state attorneys general's websites;
- Tell your clients that they will need paid expert counsel at times;
- Set up a relationship with a competent and state-appropriate lawyer whose practice centers on exempt organizations law;
- Issue-spot with this lawyer regularly. Bear in mind that getting tax-exempt status is one thing; complying with the rules afterward is another altogether, and is especially complex for private foundations;
- Make sure that your client's accountant is familiar with nonprofit-specific accounting requirements, as erroneous information returns to the IRS can result in audits;

- Get your client's board and officers properly trained, with both an overview and the specifics of exempt organizations law that apply to its activities; and finally

- Sign the nonprofit's team (and yourself) up for regular updates from well-respected advisory organizations.

Following is a list of our top 10 common, or especially detrimental, nonprofit law mistakes by pro bono counsel.

1. Assuming the Game Doesn't Change

Many pro bono lawyers assume that what worked last year will work this year, particularly where forming charities is concerned. But as part of the Pension Protection Act of 2006, Congress passed the most comprehensive federal set of charity law revisions since 1969. The charitable arena remains under active congressional scrutiny. Many states are also overhauling their applicable legislation. California changed our game by enacting the Nonprofit Integrity Act of 2004, and other states are following suit. Expect continued changes.

2. Improperly Educating Players

The corporate power structure. We can't tell you how many founding nonprofit CEOs think they run—and can fire—their board, instead of the other way around. Giving corporate officers titles such as "Board President" also doesn't help, as it further confuses

everyone involved on the actual roles of corporate officers and directors.

The differences between a tax-exempt organization and a socially conscious business. A charity's assets are irrevocably dedicated to the charitable purposes stated in its organizing document. Further, depending on its classification as

caps the number of statutorily defined "interested" directors. Thus, a California family foundation wishing to hire a family member may find that because its directors are all related to the candidate and therefore would be "interested," it must either give up the hire or lose control by adding a majority

For an excellent article on this topic from a different perspective, see "Potholes to Avoid in Road-Tripping with 501(c)(3) Organizations" by Eve Rose Borenstein, THE PRACTICAL TAX LAWYER, Winter 2007, available online at www.ali-aba.org.

a public charity or private foundation, the organization must operate within prohibitions on "private benefit," "private inurement," and/or "excess benefit." These guideposts mark the out-of-bounds area for many aspects of charity operations. For example, compensation and purchase payments cannot exceed fair market value, with specific procedural steps prescribed or required by federal law, and at times by state law. Joint ventures, partnering, and the like between a for-profit and nonprofit currently have broad gray legal areas and correspondingly high compliance costs. Loans from founders to the nonprofit (such as for formation costs) need proper documentation and board approval to be repaid, unless repayment is prohibited altogether (as under the private foundation rules). There are many other areas affected, but one in particular is often overlooked: founders must understand at the outset that, as a colleague put it, "they cannot own the nonprofit and therefore should not assign their life's work to it unless they wish to give the assets away."

The differences between private foundation and public charity status. Discussion of these is beyond the scope of this article—but again, private foundations are subject to a much more stringent legal regime and consequently need a correspondingly attentive level of assistance and compliance expertise.

3. Choosing the Wrong Home State

State law does matter at times—for example, California's "49 percent rule"

of outsiders to its board. In this case, incorporating in a state without such a rule would prevent the problem.

4. Choosing the Wrong Structure

Selecting the right form is extremely important. One common error is unnecessarily forming a corporation with voting members, resulting in statutory members' rights that can make basic corporate functions difficult and expensive. Similarly, a corporation is not always the best choice. Under certain circumstances, and depending on state laws, a trust or an unincorporated association might be a better fit.

5. Providing a Faulty Playbook

Governing documents must be carefully drafted. We've seen numerous examples of counsel making the following mistakes: (a) using "purposes" language in articles that is not necessarily charitable; (b) drafting charitable purposes too specifically for long-term use; (c) not reviewing IRS- and secretary of state-required/recommended articles language and provisions; (d) not providing bylaws that correctly steer directors on high-risk or common issues; (e) providing private-foundation bylaws content to public charities; or (f) omitting such content from private foundation bylaws.

6. Choosing the Wrong Game

Not all nonprofit organizations will qualify for tax exemption as charities. Be careful not to apply for status under section 501(c)(3) of the Internal

Revenue Code when the organization likely will not operate as a charity, but does qualify for another tax-exempt status. Similarly, on the IRS Form 1023 exemption application, many attorneys request the wrong public-charity subcategory under IRC section 170.

7. Fumbling the Public Support Test

Generally, an organization may qualify as a public charity, and thus avoid private foundation status, either by (a) being a type of entity expressly identified by statute or regulation (such as churches and colleges); (b) meeting one of the mathematical public support tests of IRC section 509(a)(1) and (2) and related regulations; or (increasingly problematic) (c) qualifying as a "supporting organization" under section 509(a)(3). Most organizations will seek to qualify under one of the mathematical public support tests. However, review of the client's revenue expectations under these tests is often overlooked, with pro bono attorneys

- Wrongly advising the client that it won't pass any public support test and therefore should apply for private foundation status;

- Conversely, advising that it will pass one of the tests when this is clearly not the case; and/or

- Most dangerous: not recognizing when a charity has in fact failed the public support test. Failure changes the organization's status and triggers the onerous private foundation rules, with violations potentially resulting in consequences for participating individuals as well as the organization.

8. Throwing an Incomplete Pass

Failing to complete all the following tasks:

- If required, the 501(c)(3) tax exemption application (IRS Form 1023). This is not complete until the charity receives a determination letter from the IRS;

- If required, a separate state tax-exemption application;

- Registration with the state attorney general's office or other charities registry, as required by most states;

- Qualification and registration as a foreign corporation when required if operating in other states; and
- Initial city and county requirements: business licensing, payroll tax registration, seller's permit, etc., as required.

This list is not comprehensive, but highlights tasks that are frequently not finished.

9. Under-Lawyer the Draft Picks

Many attorneys assume that the charity can retain executives as independent contractors and that the parties can set terms without attorney involvement. However, several areas of tension exist between tax and state law restrictions on charity compensation, on one hand, and the legal standards and market forces shaping independent contractor agreements, on the other. What your client wants to do may not be possible, especially if incentive compensation is involved. At a minimum, an exempt organizations attorney and an employment attorney should be involved from the start, before terms are set. Undoing problematic terms can be very hard on a young charity and its executives, its board, and its lawyers.

10. Not Following Through

Most charities are subject to strict tax reporting and corporate maintenance requirements. For example, for a California public charity, these requirements generally include at a minimum

- Filing the relevant IRS Form 990, including reporting unrelated business income such as periodical advertising if over \$1,000. Note that as of 2008, most low-revenue charities that did not formerly need to report to the IRS must now electronically file Form 990-N;
- Tracking and maintaining sufficient public support levels;
- Filing FTB Form 199 to report gross annual revenues of \$25,000 or more to California's Franchise Tax Board;
- Renewing its registration with the attorney general's Registry of Charitable Trusts;

• Biennially filing its Statement of Information with the secretary of state; and

- Issuing its internal annual report to the board of directors, with content specified under section 6321 of the California Corporations Code.

This does not include numerous other requirements that are common but apply only to certain activities, operations, donations, and revenue levels—such as federal, state, and local reporting regarding employees or independent contractors; seller's permits; raffles, thrift stores, and vehicle donations reporting; quarterly

payments of estimated unrelated business income tax; and others too numerous to mention. It also does not include municipal and county filings and registrations, such as business licensing, local payroll and other tax filings, and fictitious business name renewals.

Finally, a caution—since much of this area involves tax law, Treasury Circular 230 (which governs federal tax practice) and similar concerns may apply to your advice. Protect yourself—know the definition of a tax opinion, and don't go there unless it's your intent to do so.

What are the differences between “nonprofit,” “tax-exempt,” “charity,” “public charity,” and “private foundation”?

- “Nonprofit” or “not-for-profit” is typically a state corporate category.
- There are 27 different subsections of Internal Revenue Code (IRC) § 501(c) and three additional sections of the IRC under which a nonprofit may be classified as “exempt” from federal income tax.
- A “charity” is a nonprofit that operates under an organizing document that contains required provisions including, for example, that it act and use its assets only for charitable purposes as defined under IRC § 501(c)(3), and that its operations are consistent with charitable requirements. Permissible purposes are fairly broad. Section 501(c)(3) defines as charities organizations that are organized and operated for purposes that are “religious, charitable, scientific, testing for public safety, literary or educational”; “to foster amateur sports competition” if no athletic facilities or equipment are provided; or “for the prevention of cruelty to children or animals.” A wealth of statutes and regulations, IRS authority, and case law further specifies the bounds of permissible 501(c)(3) activity and operations.
- A “public charity” is a charity (such as a church or a school) that is described in IRC § 170(b)(1)(A)(i)–(v) based on its activities, or under one of various public-support tests specified under the IRC and related regulations.
- A “private foundation” is a charity that does not meet the requirements for a public charity and is governed by a more restrictive set of statutes, regulations, and other authority to ensure that it is operated for charitable purposes.